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The Manufacturers Hanover
Economic Report

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Economic Forecast For 1984

As the U.S. economic recovery approaches its first birthday, it seems to be developing a fair amount of momentum. Initially powered by increased consumer spending on autos and housing, the pickup in economic activity has now spread to other industries. What is more, after two years of liquidation, businessmen are now adding to their inventories. This is giving a further lift to the demand for materials, workers, and productive machinery. The resulting rise in capacity utilization and lengthening of delivery times have prompted some corporations to dust off their capital spending plans, suggesting that the two-year decline in these outlays may also be drawing to a close.

Does this necessarily mean that the economy will continue to grow at the relatively fast rates of speed of the second and third quarters of 1983, thereby raising the possibility of a resurgence of inflation and higher interest rates? I do not think so. I believe that the rate of expansion of business activity will slow to a more sustainable pace during the fourth quarter of this year and in 1984 as it has at this point during most postwar economic recoveries.

Inventories Boost The Economy...

The gains in the real gross national product during the first half of 1983 were enhanced by business inventory policies. Stockpiles were liquidated at a massive $22.7 billion annual rate in the fourth quarter of 1982, slowing to a $15.4 billion liquidation pace in the first quarter of 1983, and then $5.4 billion in the second quarter. Thus, of the rise of $44 billion in the real GNP that took place between the fourth quarter of 1982 and the second quarter of 1983, $17.3 billion, or 39 percent did not represent a rise in output, but came from a slowing in the pace of inventory liquidation.

This kind of push from inventory policies is not likely to continue. For one thing, as the third quarter preliminary GNP figures already reveal, there was a shift from liquidation to accumulation of business inventories. Expanding inventories entail different business strategies, labor and financing needs than cutting inventories and while more and more businessmen are becoming optimistic about the future, I do not get the impression that they are ready to go all out and build inventories as fast as possible. For one thing, as noted in the June Economic Report, there are some deterrents this time around. These include a relatively low rate of inflation, extremely high real cost of money, and ready availability of goods because of today's still-low rate of capacity utilization and overvalued dollar. For another, there is still a sizable amount of caution that pervades corporate boardrooms. Businessmen remain concerned about the longer term outlook for interest rates, inflation, and economic growth and appear to be unwilling to make more than a modest commitment toward stockbuilding.

Whenever the ongoing recovery is evaluated, it always seems to be in terms of what it means for future inflation trends. This is understandable, in view of the escalation of inflation that occurred during most of the postwar era —especially since the mid-1960s. However, as readers of these Reports know by now, the progress made against inflation this time around is unprecedented in recent economic history. What is more, inflation is likely to stay subdued because of such factors as stable oil prices, only modestly higher commodities' prices, and a salubrious combination of small wage increases and hefty improvements in labor productivity.

Along with low rates of inflation have come slightly lower interest rates. Since August, rates on high quality corporate bonds have fallen by about half of one percentage point, while commercial paper rates are off by as much as one full point. Some of this no doubt traces to market factors such as the Federal Reserve's seeming ability to get the money supply to grow within its target bands. But some probably reflects the continued good news on inflation. Interest rates on both long- and short-term instruments should decline further in the months ahead as long as economic growth and inflation

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remain moderate and the Federal Reserve is able to keep the money supply under control. In turn, these lower interest rates will enable the recovery to continue.

Business financing patterns have also played a role in recent interest rate developments. For most of this year business has been paying down short-term debt with funds obtained in the bond or stock markets. This has made room for the Treasury to borrow in order to finance its huge budget deficit. With inventories now on the rise and most business balance sheets looking better, it may not be reasonable to expect this pattern of corporate finance to continue much longer.

... While Increased Consumer Spending ...

Looking at the rest of the economy, it would appear that the consumer remains in fine shape. Although the savings rate remains below normal, incomes are growing faster than prices, leading to gains in buying power enough to enable most people to lift their rates of spending. The upcoming Holiday buying season looks like the best in several years. Last year at this time the economy was touching the low point of the recession while the unemployment rate was rising to what ultimately was a postwar high. The year before, the unemployment rate had begun to climb as well and there was a feeling that hard times lay ahead. And while the unemployment rate was declining during second-half 1980, buying power was suffering at that time because of the huge rate of inflation. To prove the point, the discomfort index (the combination of inflation and unemployment) was a high 20 at this time three years ago; today it is less than 12.

As for what consumers will buy, expect continued interest in new homes and automobiles especially if interest rates drop a touch as is generally expected. Although only about one out of every four families can afford to buy the typical new home today, this is a lot better than the situation that prevailed two years ago when fewer than one out of every six was eligible. Automobiles finally seem to have found forward gear, thanks to relatively stable prices, along with improvements in appearance and quality. Needless to say, there are a whole host of other consumer items that promise to do well in the next few months—not the least of which are personal computers, video cassette recorders and other electronic items.

The business sector will remain mixed. As noted earlier, there does appear to be a trend toward a modest inventory buildup. In addition, businessmen seem to be spending on such capital goods as business computers, telecommunications, and smaller types of machinery for purposes of modernization. However, one does not get the impression that businessmen are ready to break loose and spend more on such major capital goods as factories, office buildings, shopping centers and the like. These may pick up at some point in 1984—especially as capacity utilization reaches and goes over 80 percent, but I would not look for much in the way of this type of spending for several reasons. First, as noted earlier, the cost of money especially in real terms remains high. Second, confidence over the longer term is still relatively fragile and these kinds of capital goods are certainly long-lived in nature.

One of the major negatives that still clouds the outlook deals with our foreign trade sector. The dollar may have come down a touch compared with other key currencies, but it is still overvalued in terms of purchasing power. This means that many goods produced in the United States are simply too expensive when sold

October, 1

MHT FORECAST OF GROSS
(Seasonally Adjusted
In $ Billi

	< Actual			Projected >	
	1983				Y
	I	II	III	IV	LE
Gross National Product	3171.5	3272.0	3363.3	3450.5	331
GNP: $72	1490.1	1525.1	1554.4	1573.6	153
% Change, Annual Rates	2.6	9.7	7.9	5.0	
Consumption	2073.0	2147.0	2186.5	2238.6	216
Durables	258.5	277.7	284.2	296.5	27
Non-Durables	777.1	799.6	818.7	834.5	80
Services	1037.4	1069.7	1083.5	1107.7	107
Investment	404.1	450.1	501.0	521.7	46
Non-Residential	332.1	336.3	348.4	357.9	34
Producers Durable Equipment	199.3	208.8	217.9	224.8	21
Structures	132.9	127.4	130.5	133.1	13
Residential	111.3	128.4	140.7	140.6	13
Inventory Changes	−39.4	−14.5	11.8	23.2	−
Net Exports	17.0	−8.5	−25.9	−22.3	−
Government Purchases	677.4	683.4	701.8	712.5	69
Federal Defense	194.4	199.4	205.8	214.7	20
Federal Civilian	79.1	74.3	75.4	68.7	7
State & Local	404.0	409.7	420.6	429.1	41
Final Sales: $72	1505.5	1530.5	1549.6	1563.8	153
% Change, Annual Rates	0.6	6.8	5.1	3.7	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	219.3	21
% Change, Annual Rates	5.5	3.3	3.4	5.5	
PCE Deflator (1972 = 100)	210.1	212.5	214.5	217.1	21
% Change, Annual Rates	2.1	4.6	3.8	5.0	
Consumer Price Index (1967 = 100)	293.5	296.6	300.0	304.3	29
% Change, Annual Rates	−0.4	4.2	4.8	5.8	
Total Personal Income	2657.8	2713.6	2761.4	2831.6	274
Disposable Personal Income	2255.9	2301.0	2361.5	2419.7	233
Savings Rate	5.4	4.6	4.7	4.8	
Employment Rate	55.6	55.9	56.7	57.2	5
Unemployment Rate	10.4	10.1	9.4	8.9	
Indus. Production (1967 = 100)	138.5	144.5	151.6	156.6	14
Housing Starts (000)	1694.3	1683.0	1788.3	1610.1	169
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7535.7	687
Corporate Pre-Tax Profits	169.7	203.3	225.3	237.0	20
− Taxes	61.5	76.0	81.1	88.0	7
Net Profits	108.2	127.2	144.2	149.0	13
− Dividend Payments	71.4	72.0	73.7	76.0	7
Undistributed Profits	36.7	55.2	70.5	73.0	5
+ Depreciation	242.2	255.4	270.7	277.1	26
− Inventory Profits	1.7	10.6	15.1	18.5	1
Net Cash Flow	277.2	300.0	326.1	331.6	30

abroad, and by the same token, goods produced overseas are very cheap when sold in the United States. Over the past two years, the decline in net exports has lopped $31 billion off the real gross national product. This may not seem like much in a $1.5 trillion (real terms) economy until you realize that the third quarter 1983's real GNP was only $28 billion higher than in third-quarter 1981. If net exports had remained unchanged over this period, third-quarter 1983's real GNP would have been $59 billion above its level of two years ago and the recession would not have been as severe as it was.

... Offsets Weakness Elsewhere

Other sectors that appear to be lagging behind the economy include what is commonly known as Smokestack America, the Farm Belt, and the Oil Patch. The smokestack industries (steel, coal, copper and the like) will enjoy better times in 1984, but nowhere near a boom. This is because of the changing needs of the market place. To the extent that people are buying more automobiles and houses, they are buying smaller ones, which in some cases either imported from abroad or made with materials imported from abroad. Additionally, as noted earlier, big-ticket capital spending is not likely to pick up rapidly, further depressing the demand for steel and other building materials.

The agricultural sector will also do better in 1984 than in 1983 but, as always, is subject to the vagaries of the weather and politics. Washington's Payment In Kind program helped some farmers but not all. And some farmers benefited from the effects of the weather but others suffered. However, the combination of steady labor and oil costs should provide a lift for this important sector. As for the Oil Patch, it is in difficulty now mainly because of the expectations of some investors, bankers, and others that oil prices would climb to the sky. It must be remembered that the present level of oil prices is roughly ten times what it was ten years ago. A growing economy in the U.S. and worldwide should gradually increase the demand for oil—although obviously not in the same proportion as was the case in earlier recoveries, when the conservation ethic was not as strong.

All in all, it appears as though the current economic expansion still has some time left before difficulties pop up. As you can see from the table, we are expecting the economy as measured by the real GNP to grow in every quarter in 1984—albeit at different rates of speed. The unemployment rate should fall irregularly to the eight percent zone by this time next year while inflation will remain relatively moderate. Corporate profits are likely to climb 25 percent next year on top of a 20 percent increase in 1983. New home construction looks like it will hold at today's levels but sales of domestic automobiles are likely to climb further. The fact that 1984 is an election year should serve to bolster confidence since more times than not; the economy has grown in years divisible by four.

Trees do not grow to the sky and economic expansions do not last forever, However, a couple of statistical items are worth noting. The current expansion is now about as old as the 1980-81 upswing. That one ended prematurely, since in all of our business cycle history only two other expansions were anywhere near as short and you have to go back more than 60 years to find them. The average postwar peacetime recovery has lasted three years; including periods of war nearly four years. You can see where, from a historical standpoint, the current expansion would seem to have many more months of life left.

83
NATIONAL PRODUCT
Annual Rates)
s

AR 1983		1984				YEAR 1984	
L	% CH	I	II	III	IV	LEVEL	% CH
3	7.9	3525.0	3601.9	3682.7	3770.6	3645.1	10.0
8	3.4	1588.6	1605.2	1622.8	1641.8	1614.6	5.1
4		3.9	4.2	4.5	4.8	5.1	
3	8.5	2277.9	2321.6	2364.7	2409.0	2343.3	8.4
3	14.2	299.8	307.4	315.4	323.6	311.5	11.6
5	6.1	847.4	859.8	871.4	883.8	865.6	7.2
6	8.9	1130.7	1154.4	1177.9	1201.7	1166.2	8.5
2	13.2	529.0	546.3	569.0	595.7	560.0	19.3
7	−1.3	367.3	377.4	388.0	399.1	382.9	[illegible]
7	3.0	230.8	237.0	243.3	250.0	240.3	13.0
0	−7.7	136.5	140.4	144.7	149.1	142.7	8.9
3	43.5	142.1	144.1	150.3	156.2	148.2	13.8
7		19.6	24.8	30.7	40.4	28.9	
9		−17.9	−19.1	−21.6	−25.0	−20.9	
8	6.9	736.0	753.2	770.6	790.9	762.7	9.9
6	13.5	219.5	226.6	232.4	241.7	230.1	13.0
4	−6.2	78.8	80.8	83.0	84.8	81.9	10.1
9	6.5	437.7	445.8	455.1	464.4	450.7	8.4
4	2.9	1580.4	1595.0	1610.3	1625.6	1602.8	4.3
9		4.3	3.7	3.9	3.8	4.3	
8	4.3	221.9	224.4	226.9	229.7	225.7	4.6
3		4.9	4.6	4.6	4.9	4.6	
6	4.0	219.5	222.0	224.4	226.9	223.2	4.5
0		4.5	4.5	4.5	4.5	4.5	
6	3.3	307.8	311.4	315.0	318.6	313.2	4.9
3		4.7	4.8	4.7	4.7	4.9	
1	6.3	2885.9	2939.7	2998.0	3064.9	2972.1	8.4
5	7.3	2468.6	2513.1	2561.2	2616.0	2539.7	8.8
7		5.0	4.9	4.9	5.2	5.0	
3		57.5	57.8	58.0	58.3	57.9	
7		8.6	8.4	8.2	8.1	8.3	
3	6.6	158.7	160.2	162.0	164.3	161.3	9.2
9	60.0	1605.0	1691.4	1760.5	1743.0	1700.0	0.4
3	19.3	7734.0	7807.3	8082.5	8219.8	7960.9	15.9
9	19.9	248.6	253.5	264.1	278.6	261.2	25.1
7		93.4	95.3	100.1	106.9	98.9	
2	14.8	155.3	158.2	164.0	171.7	162.3	22.8
5	6.7	78.5	81.0	83.4	85.9	82.2	12.2
9	26.9	76.8	77.2	80.5	85.8	80.1	36.1
1		282.9	289.4	295.9	302.1	292.6	
5		18.0	16.4	17.7	19.6	17.9	
7	19.2	341.7	350.2	358.7	368.3	354.7	14.9

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Economic Report

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Politics and Economics

November is always an interesting month. Weatherwise, it tells us in no uncertain terms that the balmy days of summer and fall are over and that winter is definitely on the way. Its holidays are unique as well: On Thanksgiving Day we assemble our families and close friends and give thanks for the blessings bestowed upon us; on Veterans Day we honor those who took part in battles to defend our country, while on Election Day we exercise our right to choose those who will lead us in the months and years ahead.

Since this was an "off-year" election, attention has begun to shift to November 1984 and the Presidential elections. The economy will no doubt be an issue in the upcoming campaigns—both past performance as well as the trend of the coming months. Besides these usual characteristics, 1983's November has another claim to fame: It marks the first anniversary of the present economic recovery. As you might expect, a number of economists and politicians are claiming responsibility for this improvement in economic activity. I think it might be useful to examine these claims to see just where the credit lies.

By and large, it is the Administration and its supply-side advisors who claim credit for the current improved state of economic affairs. Talking Points, a newsletter published by the Republican National Committee, said in a recent issue that the economic progress President Reagan promised is the economic recovery we are now enjoying: "The Reagan Administration has made tremendous progress in turning our economy around."

Promises, Promises

It seems to me that the way to determine who should take the credit for the current upswing is to compare the supply-siders' promises about the economy with its actual performance. First of all, the Administration and its economic supporters promised that the economy would begin to improve starting on the day after Election Day 1980 (if they won) because they had presented what they felt was a coherent program to reduce inflation and interest rates while stimulating economic growth. A small group within this cadre, who believed in a theory known as rational expectations, felt that if the Administration could convince people that things would be different than before, people would act in such a way as to cause these desired results to occur.

For example, tax cuts, which were an integral part of the Administration's program, are normally viewed as contributing to additional expenditures by those receiving the tax relief. If these cuts were to be considered as a means toward reducing inflation, the theory went, people would not spend more, they would save more, instead, to take advantage of high interest rates without fear that their dollars' buying power would be eroded. As for investors, they would shift their preferences from precious metals, real estate and other tangible assets to such financial assets as corporate bonds and Treasury securities, if they thought inflation was going to recede. This portfolio shift would increase the supply of funds available to the capital markets so that interest rates would not rise—even if the Federal Reserve maintained a very tight rein on money growth.

About the only part of this program that worked was the slowing of inflation—and it worked not so much because people believed that inflation would slow, but because the Federal Reserve tightened up, thus causing interest rates to rise and the amount of funds available for borrowing and spending to decline. This was no new economic policy, but the traditional means by which inflation had been slowed in the past. I might add that this emphasis on tight money was part and parcel of the Administration's program. Quoting from the President's State of the Union message in January 1981: "... Our plan requires a national monetary policy which does not allow money growth to increase consistently faster

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